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COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In The Matter Of: An Investigation Pursuant to KRS 278.260 of the Earnings Sharing Mechanism Tariff of Kentucky Utilities Company	Case No. 2003-00334
In The Matter Of: An Investigation Pursuant to KRS 278.260 of the Earnings Sharing Mechanism Tariff of Louisville Gas and Electric Company	Case No. 2003-00335

RESPONSE TO THE INITIAL REQUEST FOR INFORMATION OF THE ATTORNEY GENERAL OF KENTUCKY TO BARRINGTON-WELLESLEY GROUP, INC.

FILED: October 20, 2003

B W G

Barrington-Wellesley Group, Inc.
Management Consultants

2479 Lanam Ridge Road • Nashville, IN 47448 • Tel: (812) 988-0190 • Fax (812) 988-0194

October 20, 2003

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PUBLIC SERVICE COMMISSION

Mr. Thomas Dorman, Executive Director
Kentucky Public Service Commission
P.O. Box 615
211 Sower Boulevard
Frankfort, Kentucky 40601

RE: ***AN INVESTIGATION PURSUANT TO KRS 278.260 OF THE EARNINGS SHARING MECHANISM TARIFF OF KENTUCKY UTILITIES COMPANY***
CASE NO. 2003-0334

and

AN INVESTIGATION PURSUANT TO KRS 278.260 OF THE EARNINGS SHARING MECHANISM TARIFF OF LOUISVILLE GAS AND ELECTRIC COMPANY
CASE NO. 2003-0335

Dear Mr. Dorman,

Please find enclosed one original and four copies of Barrington-Wellesley Group, Inc.'s (BWG) response to the September 26, 2003, Initial Request for Information of the Attorney General of the Commonwealth of Kentucky to Barrington-Wellesley Group, Inc.

Please contact me if you have any questions concerning this filing.

Sincerely,

Michael A. Laros

Michael A. Laros
Managing Director

Enclosures

cc: Hon. Elizabeth E. Blackford, Assistant Attorney General
Hon. Michael L. Kurtz, Boehm, Kurtz & Lowry
Hon. Kendrick R. Riggs, Ogden, Newell & Welch, PLLC
Hon. Linda S. Portasik, LG&E Energy Corp.
Mr. Michael S. Beer, LG&E Energy Corp
Mr. John Wolfram, LG&E Energy Corp.

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BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

Response to Initial Request for Information of the Attorney General
Dated September 26, 2003

Question No. 1

Responding Witness: Charles R. Parmelee

Q-1. Refer to the FINAL REPORT (Report), page I-2, the first paragraph in the section entitled "B. Overall Assessment." Is a stable ROE a desired goal since, in the capital market, capital costs change and this could deny the Companies access if capital costs in the capital market are above the upper dead-band limit? Conversely, if market cost rates are below the lower dead-band limits, there would be an incentive to diversify into potentially undesirable projects.

A-1. Yes, a stable ROE is a desired goal. It is our belief that capital markets value a steady and predictable earnings stream. In the event that market equity cost rates change so dramatically that earnings within the dead-band are no longer representative of market rates, then the Companies can petition the Commission for increases in base rates.

BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

Response to Initial Request for Information of the Attorney General
Dated September 26, 2003

Question No. 2

Responding Witness: Charles R. Parmelee

Q-2. Refer to page I-2, the second paragraph in the section entitled "B." Should the Commission allow a periodic review of the recalibration of the allowed return on equity because if the Commission does not allow a recalibration, could this hinder the service obligation when market cost rates are higher than the upper dead-band limit?

A-2. BWG does not have an opinion regarding whether the utilities' allowed returns on equity should be periodically recalibrated outside the context of a general rate case. The utilities made commitments to the Commission regarding its service obligations as part of entering into the ESM.

Based on the results of this audit, we believe the utilities have fulfilled, and intend to continue to fulfill, these commitments. In the event that market cost rates are higher than the upper dead-band limit we would expect the utilities to petition the Commission for an increase in base rates, if needed, in order to meet the needs of both ratepayers and shareholders.

BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

Response to Initial Request for Information of the Attorney General
Dated September 26, 2003

Question No. 3

Responding Witness: Joel F. Jeanson

Q-3. Refer to page I-2, the last paragraph on the page. Please explain how "an economic/risk based capital budgeting process" is consistent with "a reliability-centered asset management program?"

A-3. A reliability-centered asset management program is focused on maintaining assets using a predictive approach. Rather than perform maintenance on all plant of a certain type and vintage on a specified schedule, reliability centered asset management uses predictive techniques to focus maintenance activities of plant most likely to fail, thus improving reliability.

An economic/risk-based capital budgeting process is consistent with a reliability-centered asset management program in that it makes decisions regarding capital expenditures, rather than maintenance expenses, using a similar predictive approach.

BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

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Dated September 26, 2003

Question No. 4

Responding Witness: Michael A. Laros

Q-4. Refer to page I-2, the last paragraph on the page that is continued at the top of page I-3. Would it be appropriate to conclude that the improved service reliability is independent of the ESM and that the ESM neither provided an incentive nor a disincentive for service reliability in light of potentially rising or falling capital cost rates?

A-4. As stated in Finding No. VIII-2 on page VIII-3 of the report, "The Companies place considerable emphasis on service levels, customer satisfaction, and safety as part of the planning, budgeting, capital expenditure, and performance monitoring activities."

We believe management was sufficiently attuned to the reliability concerns of the Commission to recognize that declining service levels would not bode well for the continuation of the ESM. Hence we cannot state that the ESM neither provided an incentive nor a disincentive for service reliability. We do not understand the reference to "in light of potentially rising or falling capital cost rates."

BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

Response to Initial Request for Information of the Attorney General Dated September 26, 2003

Question No. 5

Responding Witness: Charles R. Parmelee

Q-5. Refer to page I-9, the paragraph that starts at the bottom of the page and continues at the top of page I-10. This paragraph states that one "COSR flaw" is "to promote growth and maximize the utilization of existing plant" which causes the need to build "higher cost plant" which in turn causes rates to increase.

a. Should the term "promote growth" be more appropriately phrased as "promote growth by encouraging the inefficient use of electricity?"

b. How is the promotion of growth through the efficient use of electricity undesirable regardless of the effect on the local economy?

c. What is the effect of allowing CWIP in the rate base and the use of AFUDC accounting between rate cases an incentive or disincentive in COSR?

d. Explain how meeting permanent (base) load growth with combustion turbine units is desirable?

A-5.

a. No.

b. BWG has not characterized growth as undesirable. We simply indicate that at some point growth will inevitably lead to the need to procure an additional source of supply. The most appropriate long-term solution may be the construction of new generating facilities. The incremental cost associated with this new plant may be greater than imbedded costs, which will then require that rates increase.

c. An evaluation of the effect of allowing CWIP in rate base and the use of AFUDC accounting between rate cases as an incentive or disincentive in COSR is not within the scope of this assignment.

d. BWG stated that “many utilities have been meeting increased load with combustion turbine units, which may be less than embedded cost.” Combustion turbines are typically used to meet increased peak period demands, not base load growth.

BARRINGTON-WELLESLEY GROUP, INC.

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Response to Initial Request for Information of the Attorney General
Dated September 26, 2003

Question No. 6

Responding Witness: Charles R. Parmelee

Q-6. Refer to page I-9, the paragraph that starts at the bottom of the page and continues at the top of page I-10 and explain how the ESM design corrects or exasperates this "COSR flaw."

A-6. Under the earnings sharing mechanism as well as traditional regulation, utilities have a short-term incentive to promote growth and maximize the utilization of existing plant. The current ESM design neither corrects nor exacerbates this COSR weakness; however ESM does allow customers to share in the benefits of the increased plant utilization if earnings exceed the upper dead-band limit.

BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

Response to Initial Request for Information of the Attorney General
Dated September 26, 2003

Question No. 7

Responding Witness: Charles R. Parmelee

Q-7. Refer to the next to the last paragraph on page I-10. Here the Report indicates that the Companies have significant under-earnings in 2002 and will "remain in an under-earning position for the next several years." Please explain the effect of several years of under-earning with the hope of only recovering 40% of the under-earnings on:

a. Capital costs?

b. Dividends to E.On U.S.?

c. Maintenance of existing plant?

d. Construction of T&D plant?

e. Building base-load, low operating cost generation plant?

f. Service reliability?

A-7.

a. Significant periods of under-earnings without remedy, or the reasonable expectation of remedy, will likely result in increased capital costs.

b. Dividends to E.On U.S. are likely to decrease.

c. As mentioned on page I-2 of the Report, the "Companies have sound planning, budgeting and accounting processes and good expenditure control. The Companies have participated in numerous process improvement changes over the past several years including during the trial ESM period (2000-2002). These changes include implementing a shift towards a reliability-centered asset management program, a variable workforce, and an economic/risk-based capital budgeting process." BWG expects these efforts to continue; however, also see Chapter IV, Management Practices, in which BWG recommends that the Company:

> *"Directly link the executive short-term incentive program to the ESM. Senior executives responsible for any part of LG&E/KU's*

> *operation or administration should have a meaningful portion of their short-term incentive opportunity linked to the two utility operating companies meeting and exceeding their allowed rates of return. The incentive payments would be reduced if the allowed rate of return is not achieved.*
>
> *The allowed rate of return is set by a deliberative process that is intended to provide adequate financing for the operating utilities and a fair return to investors. When the allowed rate of return is not achieved, it jeopardizes the utilities' financing capability and shortchanges the investors, in this case, E.ON.*
>
> *Achievement of reliability and customer service goals should continue to be a major factor in the individual performance portion of the incentive programs. Achievement of allowed rates of return should not be at the expense of reliability and customer service. Executives, managers and employees should continue to be expected, and provided incentives, to achieve both financial and operating performance success."*

d. Same as response to "c" above.

e. BWG expects the construction of an additional base-load, solid-fuel generating station will result in the Companies filing a general rate case regardless of whether it is in an ESM under- or over-earnings position.

f. On page I-3 of the Report, BWG states the "Companies have generally maintained, and in some cases improved, already high levels of service reliability and customer satisfaction during the trial period." BWG expects the Companies to maintain high service reliability and customer satisfaction levels. However, also see response to "c" above.

BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

Response to Initial Request for Information of the Attorney General
Dated September 26, 2003

Question No. 8

Responding Witness: Charles R. Parmelee

Q-8. Is BWG aware that the Companies retain the statutory right to seek a base rate increase in the event of under-earning and have stated that they will do so if necessary? Should continued under-earnings cause the companies to seek and increase in base rates during the term of an ESM, what effect would the increase in base rates have on the symmetry of the operation of the ESM and on the fairness of the 60/40 sharing of over- and under-earnings?

A-8. Yes, BWG is aware that the Companies retain the statutory right to seek a base rate increase in the event of under-earning and have stated that they will do so if necessary.

BWG does not believe that an increase in base rates should have any effect on the symmetry of the operations of the ESM or on the fairness of the 60/40 sharing of over- and under-earnings.

BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

Response to Initial Request for Information of the Attorney General
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Question No. 9

Responding Witness: David P. Vondle

Q-9. Refer to the last paragraph on page I-10. Why should O&M Expense per Customer be in line with customer growth?

A-9. New customers require additional investments to serve them, increasing depreciation, and additional expenses to set up new accounts, hook up service, run credit checks and so forth that existing customers do not require. Customer expense per customer is typically higher in growth periods than in static periods.

BARRINGTON-WELLESLEY GROUP, INC.

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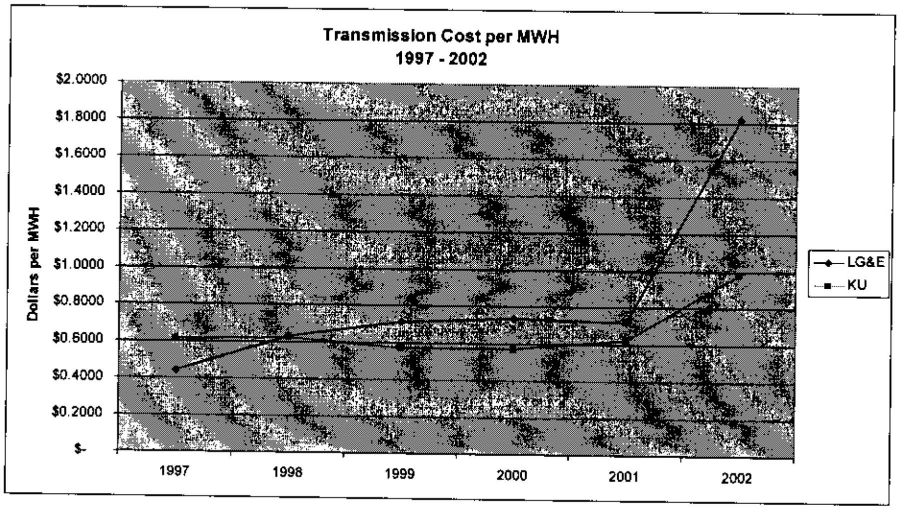
Response to Initial Request for Information of the Attorney General
Dated September 26, 2003

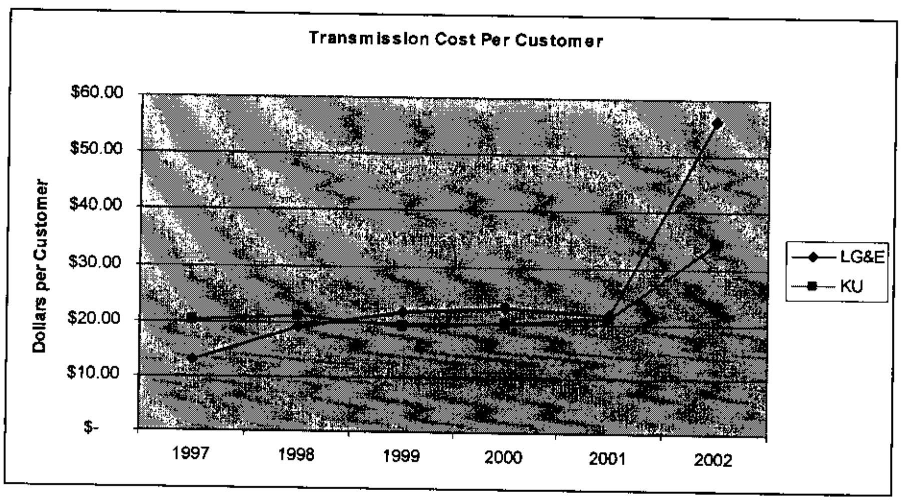
Question No. 10

Responding Witness: Joel F. Jeanson

Q-10. Refer to the graph on page I-11. Transmission cost is graphed on a "per-customer" basis. Would the graph be the same on a "per-Mwh" basis?

A-10. Yes. See below.





BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

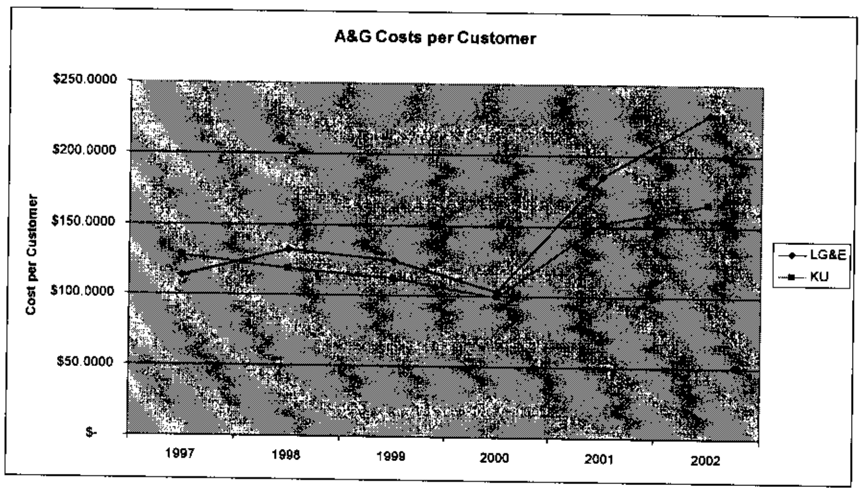
Response to Initial Request for Information of the Attorney General
Dated September 26, 2003

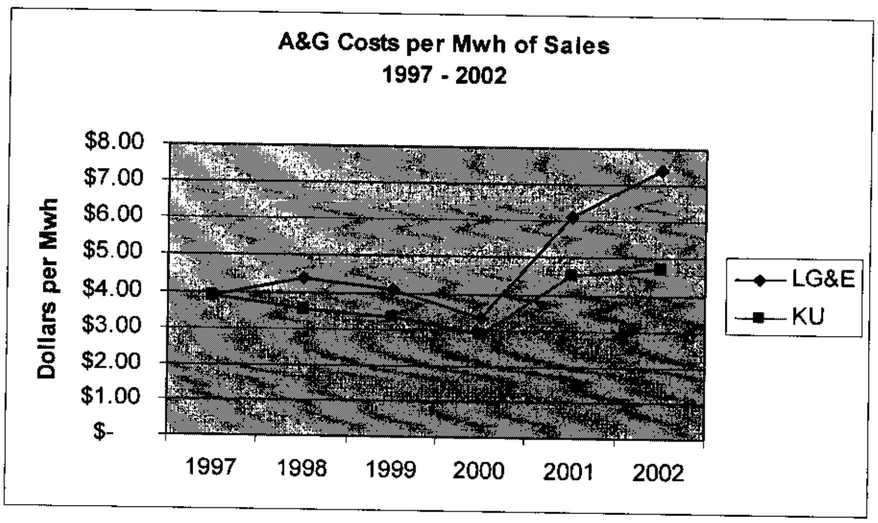
Question No. 11

Responding Witness: Joel F. Jeanson

Q-11. Refer to the graph on page I-13. A&G Costs are shown on a "per-Mwh" basis. Would the graph be the same on a "per-Customer" basis?

A-11. Yes. See below.





BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

Response to Initial Request for Information of the Attorney General Dated September 26, 2003

Question No. 12

Responding Witness: Michael A. Laros

Q-12. Refer to the next to the last paragraph on page I-13. Did BWG perform any evaluation to determine the reasonableness of the "MISO-related" (Midwest Independent System Operator) expenses?

A-12. No, an evaluation of the reasonableness of the "MISO-related" (Midwest Independent System Operator) expenses was not within the scope of this assignment.

BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

Response to Initial Request for Information of the Attorney General
Dated September 26, 2003

Question No. 13

Responding Witness: Joel F. Jeanson

Q-13. Since the MISO related expenses are start-up costs, shouldn't these be capitalized and amortized over a period of time?

A-13. The Company has indicated that it cannot readily distinguish the amount billed by MISO directly related to start-up charges. If identified, the Company could request the costs be deferred (and a regulatory asset established) pending recovery in rates. Absent specific Commission authorization, deferring and amortizing these costs would not be consistent with GAAP.

BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

Response to Initial Request for Information of the Attorney General
Dated September 26, 2003

Question No. 14

Responding Witness: Joel F. Jeanson

Q-14. Refer to the two graphs on page I-12. Both graphs show that "Cost(s) per Customer" increased in the year 2002. What were the causes of these cost increases?

A-14. BWG Data Request 1-21 requested copies of responsibility reports for 1998-2002. These responsibility reports provided explanations for variances compared to budget and compared to the prior year. These reports were provided confidentially, and BWG has not retained copies of these reports.

However, in response to BWG Data Request 4-69, the Company provided copies of all correspondence, including data requests and responses, associated with the 2002 ESM filing case. Included in the responses were explanations for increases in certain costs which do explain, at least in part, the reasons for the increases questioned.

First, the Companies experienced significant increase in employee labor burden costs, largely related to an increase in pension costs. Second, and primarily related to retail costs, the Company increased its use of outside contractors. The use of contractors is consistent with the Company's variable workforce Value Delivery Team initiative. While the implementation of a variable workforce is expected to result in cost savings, in the short-run, costs may increase as the workforce transitions from using Company labor to using Contractor labor. While specifically mentioning retail costs (e.g., contract meter readers and field service order processors), this would likely apply to distribution operations as well.

BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

Response to Initial Request for Information of the Attorney General
Dated September 26, 2003

Question No. 15

Responding Witness: Charles R. Parmelee and Joel F. Jeanson

Q-15. Refer to page I-15, the next to the last paragraph on the page. Here the Report indicates that "ratepayers receive the benefit of lower interest rates" when interest rates fall and "shareholders are protected in periods of rising interest rates." From a ratepayer's perspective, is this a perverse weakness of the ESM because ratepayers may have more disposable income to pay electric bills during periods when interest rates are low, and less disposable income to pay electric bills during periods of high interest rates?

A-15. No. Ratepayers would expect to see the benefits of lower interest rates reflected in their utility bills as well as the cost of higher interest rates.

BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

Response to Initial Request for Information of the Attorney General
Dated September 26, 2003

Question No. 16

Responding Witness: David P. Vondle

Q-16. Refer to page I-18, "Task Area 1 - Affiliate Transactions." Please state for each finding, 1 through 5, whether each is considered to be a strength or a weakness.

A-16.
1. Strength
2. Weakness
3. Weakness
4. Weakness
5. Strength

Please see Chapter III for a more detailed explanation of each of these findings and their support.

BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

Response to Initial Request for Information of the Attorney General Dated September 26, 2003

Question No. 17

Responding Witness: David P. Vondle

Q-17. Refer to page I-22, the section on "Affiliate Transactions," the recommendation given as priority A. Is it really possible to create a position, that has objectives contrary to the interest of the shareholders, that would not have conflicts of interest?

a. Who would the person holding this recommended position report to?

b. How would that person's performance review be determined?

c. How would the salary of the person holding the recommended position be determined?

A-17. The recommended utility executive would not have conflicts of interest with the shareholders. Nor would the recommended utility executive have conflicts of interest with the unregulated portions of LEC. Achieving the allowed rate of return is in the interest of the investors and ratepayers.

a. The recommended position would report to the LEC CEO.

b. The recommended utility executive's performance review would be based upon all aspects of the regulated utilities performance, including financial, reliability, customer service, regulatory relationships, and safety.

c. The salary of the recommended utility executive would be determined by the Company's normal process, including comparisons to similar utility executive positions.

BARRINGTON-WELLESLEY GROUP, INC.

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Response to Initial Request for Information of the Attorney General
Dated September 26, 2003

Question No. 18

Responding Witness: David P. Vondle

Q-18. Refer to page I-19, the findings for "Task Area 2 - Management Practices" and to Page I-22, the recommendations for "Task Area 2 - Management Practices." Please relate each recommendation for the "Management Practices" to the findings for "Management Practices."

A-18. The recommendation for "Task Area 2 - Management Practices" relates to Finding 3. For a further discussion of this finding and the relate recommendation, please refer to Chapter IV of the report. As a general rule, recommendations are only provided for findings where a weakness is identified.

BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

Response to Initial Request for Information of the Attorney General Dated September 26, 2003

Question No. 19

Responding Witness: David P. Vondle

Q-19. Refer to page I-22, "Management Practices." The second paragraph states that, "The allowed rate of return is set by a deliberative process that is intended to provide adequate financing for the operating utilities and a fair return to investors. When the allowed rate of return is not achieved, it jeopardizes the utilities' financing capability and shortchanges the investors, in this case, E.On."

a. Is this a finding or a recommendation?

b. Should the annual filings be accompanied by a deliberative return on equity finding?

c. Specifically, what is the recommendation associated with this paragraph?

d. Does this paragraph simply provide emphases for the need to tie the short-term incentive program to the ESM?

A-19.

a. It is support for the recommendation to link executive short-term incentive compensation to the ESM. For a further discussion of this recommendation and the related finding, please refer to Chapter IV of the report.

b. No. BWG is not recommending that the annual ESM filings be accompanied by a deliberative return on equity finding.

c. It is support for the recommendation to link executive short-term incentive compensation to the ESM.

d. Yes.

BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

Response to Initial Request for Information of the Attorney General
Dated September 26, 2003

Question No. 20

Responding Witness: Charles R. Parmelee

Q-20. Refer to page I-19, the findings for "Task Areas 3 and 4 - ESM Structure." The third finding of the Report indicates that, "Business and regulatory risk are reduced by the ESM adjustments to rates as the return on equity deviated from the dead-band. The ESM tends to stabilize the return on equity."

a. How should the return on equity be adjusted when it is established using comparable companies?

b. Should the target return on equity be reduced because of the smaller business and regulatory risk premium?

c. If the answer to part b is yes, please explain.

d. If the answer to part b is no, please explain.

A-20.

a. BWG is not recommending the authorized rate of return on equity be adjusted as part of the annual ESM filing. The ESM stabilizes the achieved return on equity by decreasing revenues when the return is above the upper dead-band limit and by increasing revenues when the return is below the lower limit.

b. BWG is not aware of the deliberations that occurred in the rate proceeding that established the current, authorized rate of return on common shareholders equity.

c. See response to "b" above.

d. See response to "b" above.

BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

Response to Initial Request for Information of the Attorney General
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Question No. 21

Responding Witness: Charles R. Parmelee

Q-21. Refer to page I-15, the paragraph beginning with "Exhibit I-7." Here it is stated that, "Changes in the weighted average cost of capital can occur as a result of changes in interest rates or capital structure." On page I-20, a finding in the Report indicates that a weakness of the ESM is that it "provides no direct control over financing costs or capital structure."

a. Why isn't there a recommendation on page I-23 that deals with capital structure?

b. Would a capital structure control be desirable?

c. If the answer is yes, what type of control would BWG recommend?

d. If the answer is no, please elaborate on the "other means to exert control" that the Commission has to control the capital structure.

A-21.

a. BWG believes the other means the Commission has to exert control over financing costs and capital structure are sufficient.

b. As stated above, the Commission has other means to exert control over financing costs and capital which BWG believes are sufficient.

c. Not applicable.

d. The Commission must approve the issue of securities or evidences of indebtedness by a regulated utility. The Commission also may exert control over capital structure in a general rate case, or in any case in which capital structure is an issue.

BARRINGTON-WELLESLEY GROUP, INC.

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Question No. 22

Responding Witness: Charles R. Parmelee

Q-22. Does BWG consider these "other means" that the Commission has to control the capital structure effective?

a. If yes, please elaborate.

b. If no, please elaborate.

A-22. Yes, see response to question 21d.

BARRINGTON-WELLESLEY GROUP, INC.

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Response to Initial Request for Information of the Attorney General
Dated September 26, 2003

Question No. 23

Responding Witness: Charles R. Parmelee

Q-23. Has BWG considered other measures of performance other than return on equity since this measure requires the use of a capital structure and interest rates in its calculation?

A-23. No. BWG believes the use of a dead-band based on actual capital structures and debt financing costs is reasonable and appropriate, given that the Commission has means to indirectly control these items.

BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

Response to Initial Request for Information of the Attorney General
Dated September 26, 2003

Question No. 24

Responding Witness: Charles R. Parmelee

Q-24. If the answer to the previous question is yes, what other measures were considered?

A-24. Not applicable.

BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

Response to Initial Request for Information of the Attorney General
Dated September 26, 2003

Question No. 25

Responding Witness: Charles R. Parmelee

Q-25. Refer to page I-23, "ESM Structure." Please relate the three recommendations to the five weaknesses shown at the top of page I-20.

A-25. The first weakness shown on the top of page I-20 is not addressed by any of the three recommendations on page I-23.

The second weakness shown on the top of page I-20 is not addressed by any of the three recommendations on page I-23.

The third weakness shown on the top of page I-20 is not addressed by any of the three recommendations on page I-23.

The fourth weakness shown on the top of page I-20 is addressed by the first recommendation on page I-23.

The fifth weakness shown on the top of page I-20 is addressed by the third recommendation on page I-23.

BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

Response to Initial Request for Information of the Attorney General
Dated September 26, 2003

Question No. 26

Responding Witness: Charles R. Parmelee

Q-26. Refer to page I-23, "ESM Structure." The first recommendation suggests that a "multi-year" ESM be used to reduce the effect of timing issues. This recommendation is discussed further on page V-8, item 1.

a. Specifically, how many years does BWG recommend be used?

b. Does this recommendation envision an annual filing or a multi-year filing?

A-26.

a. The example ESM period discussed on page V-8 is a three year period, although we indicate "a longer period may also be appropriate."

b. Both annual and multi-year filings.

BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

Response to Initial Request for Information of the Attorney General
Dated September 26, 2003

Question No. 27

Responding Witness: David P. Vondle

Q-27. Refer to the first audit objective on page II-1 in the Report. This objective specifically requests that the efficiencies be tied to the ESM incentive plan. Now refer to the findings listed on pages I-18 through I-21. Identify the findings shown on these pages that indicate that the ESM has provided the incentives or otherwise caused the companies to initiate efficiencies.

A-27. Task Area 2, Management Practices, Findings 1 and 2 refer to the continuous improvement programs the Companies implemented and their success. There are no findings that indicate that the ESM has provided incentives or otherwise caused the companies to initiate efficiencies.

BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

Response to Initial Request for Information of the Attorney General
Dated September 26, 2003

Question No. 28

Responding Witness: Michael A. Laros

Q-28. Refer to the second audit objective on page II-1 in the Report. This objective specifically asks what effects the ESM plan has had on service levels. Refer once again to the findings listed on pages I-18 through I-21 and identify which findings indicate that the companies have increased their service level as a result of the ESM plan.

A-28. The areas of investigation requested by the Commission to address this issue are identified on page II-2, Task Area 7, as follows:

> *"Review the Companies' compliance with both the Commission's service-related regulations and their own service objectives, both internal and external, since the incentive plan was instituted."*

Findings VIII-1 through VIII-5 all relate to these areas of inquiry. There are no specific findings that "the companies have increased their service level as a result of the ESM plan."

For a further explanation of the work tasks, evaluation criteria, findings and conclusions, and recommendations, please refer to Chapter VIII of the report.

BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

Response to Initial Request for Information of the Attorney General
Dated September 26, 2003

Question No. 29

Responding Witness: David P. Vondle

Q-29. Refer to page III-2 in the Report, the next to the last full paragraph on the page. The Report indicates that substantially all product and service transactions among LEC affiliates are processed through Servco. Now refer to Exhibit I-1, on page I-4. Where does Servco fit on the Corporate Organization Chart?

A-29. As identified in the last full paragraph on page I-2, the formal name for "Servco" is LG&E Energy Services, Incorporated. Referring to Exhibit I-1, LG&E Energy Services, Inc. is one of the subsidiaries reporting to LG&E Energy Corp. and is shown as the box labeled, "LG&E Services, Inc."

AG, Q30

BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

Response to Initial Request for Information of the Attorney General
Dated September 26, 2003

Question No. 30

Responding Witness: David P. Vondle

Q-30. If an informal decision-making organization chart was presented (rather than a corporate organization chart), would Servco be positioned where LG&E Energy Corp. is positioned in the Corporate Organization chart shown in Exhibit I-1 on page I-4?

A-30. Most executives serve both regulated and unregulated companies and are technically employees of the Services Company. The actual reporting relationships among executives do not match the legal entity structure. For example, an individual who is technically an employee of a regulated utility may report to an individual who is technically an employee of Servco. Developing an informal decision-making chart was not in the scope of this assignment.

AG, Q31

BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

Response to Initial Request for Information of the Attorney General
Dated September 26, 2003

Question No. 31

Responding Witness: David P. Vondle

Q-31. Refer to page III-2 in the Report, the next to the last paragraph on the page. The Report indicates that "LGE was allocated $95 Million and KU was allocated $75 million.

a. What allocation method was used to distribute the joint costs?

b. What steps did BWG take to assure that the allocation method that was used is appropriate given the nature of the costs that were involved?

c. Was any attempt made to examine the trend in these costs as was done on pages I-11 and 1-12 of the Report?

d. Would it be correct to say that LG&E and KU accounted for 54% of Servco's cost ($335 million divided by $616 million) rather than "about 50% of Servco's costs?"

A-31.

a. Multiple allocation methods were used. There was an allocation method specified and used for each type of expense.

b. We reviewed the Cost Allocation Manual and interviewed the accountant in charge of its implementation. We also reviewed the relevant internal audit reports and interviewed the head of internal auditing.

c. No. Servco is a relatively new entity.

d. Yes.

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Response to Initial Request for Information of the Attorney General
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Question No. 32

Responding Witness: David P. Vondle, Charles R. Parmelee and Joel F. Jeanson

Q-32. Refer to page III-3, the last paragraph on the page. The report states that, "From 2001 forward, the payment of dividends became principally a tool for managing the operating companies' capital structures to conform with the Merger Agreement and to maintain financial credit ratings."

a. What capital structure does the Merger Agreement require?

b. How did BWG determine that the capital structures of LG&E and KU will maintain the Companies' financial credit ratings?

c. In BWG's evaluation, what is the optimal capital structure for LG&E?

d. In BWG's evaluation, what is the optimal capital structure for KU?

e. The Report, on page I-20, indicates that the Commission can exert control over the Companies' capital structure. Can the Commission control the amount of dividend payment that the Companies make?

f. What is meant by keeping the "capital structures of the operating companies in balance?"

A-32.

a. In Appendix A of the Commission Order dated August 6, 2001 in the matter of the Joint Application for the Transfer of Louisville Gas and Electric Company and Kentucky Utilities Company in Accordance with E.ON AG's Planned Acquisition of Powergen plc, Case No. 2001-104, the Commission indicates the companies shall adhere to the conditions of previous orders as restated in Appendix B to the Commission's May 15, 2000 Order in Case No. 2000-095.

The financial resources section of Appendix B to the Commission's May 15, 2000 Order in Case No. 2000-095, states that "the Commission believes that LG&E Energy and PowerGen should assist the utilities in maintaining a balanced capital structure," "the dividend policy must not adversely affect the utilities' ratepayers, and the utilities, through their boards of directors, have the responsibility to use their dividend policy consistent with preserving the financial strength of the utility," and "any action or decision by the board of directors of LG&E Energy or Powergen, including the unwillingness to provide adequate capital to KU and LG&E, that, in any way, impairs KU's or LG&E's ability to provide adequate, efficient, and reasonable utility service, will be in direct violation of KRS 278.030(2)."

The Commission in this Order approving the merger does not specify a required capital structure.

b. Through an interview with Dan Arbough, Director – Corporate Finance and Treasurer, on May 29, 2003, in which Mr. Arbough stated that the capital structure is managed through the dividend policy to keep what the Companies expect rating agencies would want to see to maintain an A1 rating.

c. BWG has not evaluated the Company with the intention of determining an optimal capital structure for LG&E.

d. BWG has not evaluated the Company with the intention of determining an optimal capital structure for KU.

e. Pursuant to Commission Orders in Case Nos. 2000-095 and 2001-104, the Companies must notify the Commission 30 days prior to paying any dividend or transferring more than 5 percent of the retained earnings of LG&E and KU to E.ON and/or Powergen.

f. This phrase is not defined in the Orders; however, based on our experience, in the utility industry it historically has meant maintaining equity-to-debt ratios between 60/40 and 40/60.

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Question No. 33

Responding Witness: David P. Vondle, Charles R. Parmelee and Joel F. Jeanson

Q-33. Refer to page V-10, Exhibit V-3. The capital structure shows that LG&E has an equity component of approximately 50%. KU has an equity component of approximately 60%. KU has approximately 10 percentage points more equity than LG&E.

a. How does this conform with the statement on page III-3 that dividends are used to keep the capital structures in balance when in 2002 KU paid no dividends and LG&E paid $69 million?

b. Since KU paid no dividends in 2002, did the equity component in its capital structure increase?

c. Does BWG believe that is reasonable for KU to have 10 percentage points more equity than LG&E?

d. Should both companies have the same target ROE when KU has less financial risk than LG&E?

A-33.

a. BWG discussed the apparent discrepancy in capital structures with Mr. Arbough, Director – Corporate Finance and Treasurer, on May 29, 2003. When adjusted for environmental costs and for imputed debt associated with long-term purchased power commitments, KU's capital structure is in line with LG&E's.

b. No. KU's increased equity was matched by increases in short-term debt, long-term debt and accounts receivable securitization and, as a result, its capital structure remained virtually unchanged for 2001 to 2002.

c. See answer "a" above.

d. Not applicable. See answer "a" above.

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Question No. 34

Responding Witness: David P. Vondle, Charles R. Parmelee and Joel F. Jeanson

Q-34. Refer to page III-4, Exhibit III-4 and the text under the Exhibit. It is indicated that LG&E and KU paid $329.3 million in taxes to LEC.

a. Was this a cash payment or was a portion of the amount deferred?

b. If a portion of the $329.3 million was deferred, how do the operating companies account for deferred taxes?

c. Do LG&E and KU include deferred taxes in the annual ESM filings?

A-34.

a. Cash. Actual cash transfers may be netted against amounts owed by the other party.

b. The $329.3 million represents the total tax expense recorded on the financials statements of Louisville Gas and Electric Company and Kentucky Utilities – which includes a provision for deferred taxes. The operating companies account for income taxes in accordance with GAAP, which included a provision for deferred taxes.

c. Yes. See ESM filing Form 2.

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Question No. 35

Responding Witness: David P. Vondle, Charles R. Parmelee and Joel F. Jeanson

Q-35. The text under Exhibit III-4 indicates that LEC paid $23.3 million to the U.S. Treasury in 2000 and 2001. In addition, LEC paid $22.7 million to Powergen in 2002 even though Powergen had no tax liability in 2001 and 2002. If the LG&E payments and the KU payments were cash payments, where does the money go? E.g. Does it get loaned back to the operating companies or other affiliated companies or what?

A-35. There are no known restrictions on the use of the cash payments to the parent for taxes. It enters the parent's cash pool and can be used for any purpose at the parent's discretion.

AG, Q36

BARRINGTON-WELLESLEY GROUP, INC.

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Response to Initial Request for Information of the Attorney General
Dated September 26, 2003

Question No. 36

Responding Witness: David P. Vondle

Q-36. Refer to page III-4, the next to the last paragraph on the page. It is stated that Powergen provides back-up LEC cash pool lending when E. ON North America cannot meet the needs.

a. Is one of the sources of funds that Powergen loans derived from the operating company tax payments?

b. If the answer to part a. is yes, what is the interest rate charged on these funds?

A-36.

a. Not known. The parent could choose to apply cash from subsidiary tax payments to loans to subsidiaries.

b. Not applicable.

AG, Q37

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Response to Initial Request for Information of the Attorney General
Dated September 26, 2003

Question No. 37

Responding Witness: David P. Vondle

Q-37. Refer to page III-4, the bottom paragraph on the page. If Ergon is a captive Powergen insurance company, why is Risk Management Services, a non-affiliated company, used by Servco?

A-37. The use of insurance management services is a common business practice. In this case, the non-affiliated insurance management service recommended an affiliated insurance supplier. The insurance management service also recommends non-affiliated suppliers for other insurance needs.

AG, Q38

BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

Response to Initial Request for Information of the Attorney General
Dated September 26, 2003

Question No. 38

Responding Witness: David P. Vondle

Q-38. Refer to item 3 on page III-8. Are the Service Level Agreements "not used as intended" or are they simply not used.

A-38. The Service Level Agreements exist, but are not actively used by the provider and purchaser of the services to manage the provision of service. They are paper documents, but are ignored from day to day.

AG, Q39

BARRINGTON-WELLESLEY GROUP, INC.

CASE NOS. 2003-00334 & 2003-00335

Response to Initial Request for Information of the Attorney General
Dated September 26, 2003

Question No. 39

Responding Witness: David P. Vondle

Q-39. Refer to page III-9, item 5 which states that the basis for costing and pricing transaction between LG&E/KU and affiliates is appropriate and supported ... and there is no cross subsidization between regulated and non-regulated affiliates.

a. What independent tests did BWG perform to substantiate that the basis for costing and pricing transactions between the operating companies and affiliates appropriate?

b. Was any reliance placed on the Servco US Audit Services report described in next to the last bulleted statement on page III-9 in concluding that the costing pricing of transaction is appropriate and supported?

c. Is the conclusion of item 5 on page III-9 clouded by the findings of item 2 on III-6?

A-39.

a. Independent testing of individual transactions was not in the scope of this study. See the response to Question 31.

b. Relevant internal audit reports were reviewed and contributed to our finding.

c. Finding Number 5 on page III-9 is not clouded by Finding Number 2 on page III-6. We found no accounting problems. We found organizational separation problems.

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Response to Initial Request for Information of the Attorney General Dated September 26, 2003

Question No. 40

Responding Witness: Charles R. Parmelee

Q-40. Refer to page V-6, the first two bulleted paragraphs on the page which deal with "Capital Additions" and "Capital Structure." These are pointed out as weaknesses, and yet the Report does not make any recommendations concerning these items. Why?

A-40. With regard to Capital Additions, this was identified as a generic weakness in Earnings Sharing Mechanism programs along with the comment that "ESM was never expected to yield acceptable results in the event the company made a large capital addition…" (Report, Page V-6).

With regard to Capital Structure, this was also identified as a generic weakness in Earnings Sharing Mechanism programs, along with the comment that "the Commission has other means to exert some control over these items" (Report, Page V-6). See also response to Question 21.

BWG has no additional recommendations regarding these issues.